US Embassy Jakarta
ECONOMIC SECTION

INDONESIA: ECONOMIC AND FINANCIAL HIGHLIGHTS
JULY 2006

Summary:

- The Central Bureau of Statistics (BPS) announced on August 2 a slowing year-on-year (YoY) inflation in July 2006 of 15.15%.
- Bank Indonesia (BI) lowered interest rates on August 8 by 50 basis points (bps) to 11.75%.
- On July 26 Standard & Poor's Rating Services raised Indonesia's long-term currency rating citing improving fiscal performance.
- On July 12, the Ministry of Finance presented the Government of Indonesia's mid-year revision of the 2006 Budget to Parliament.
- The revised budget assumes a higher oil price of USD 62 per barrel and lower economic growth of 5.9%.
- On July 17, the Ministry of Finance launched Indonesia's first three-year "retail" bonds to individuals, which pay interest monthly and offer a 12.05% fixed coupon rate.
- The Government of Indonesia (GOI) earned USD 617 million from a monthly bond offering on July 12.
- On July 25, the GOI swapped USD 265 million bonds maturing in 2007–09 as part of its bond re-profiling program.
- On July 5, the GOI and Bank Indonesia (BI) launched a financial sector reform policy package.
- On July 10, Finance Minister Sri Mulyani Indrawati announced, as part of the package, a new regulation allowing state-owned banks the same flexibility enjoyed by private banks in addressing their non-performing loans.
- On July 25, Director General for Treasury Mulia Nasution announced the closing of 300 government accounts with individual officials as account holders.
- On July 24, Bank Indonesia signed a Memorandum of Understanding (MOU) with Malaysia's Central Bank, on improving human resources especially in the Islamic financial sector.
- Several major banks reported their performance in the first half of 2006; loans in the "loss" category increased.
- An exchange rate of 9,070 per USD is used throughout this report.

Inflation Slowing:
BI Cuts Interest Rate to 11.75%

On August 2, the Central Bureau of Statistics (BPS) announced that inflation is slowing down. July inflation was 15.15% year-on-year (YoY), and 0.45% month-on-month (MoM). Core inflation went up by 0.36% MoM, and 9.58% YoY. In a widely expected move, Bank Indonesia (BI) on August 8 cut its benchmark interest rate by 50 bps to 11.75%. Coordinating Minister for Economic Affairs Boediono reportedly stated, "I think BI has moved in the right direction and that there is still room for more cuts. For our part, we will follow up by continuing to improve the investment climate, as high interest costs are not the only factors impeding growth." Minister for Industry Fahmi Idris reportedly stated on August 9, "It's positive, but still far from what the business community and the real sector have been hoping for."

CPI Components

Components	MoM	YoY
Food stuff	0.99	15.77
Food, beverages, tobacco, cigarettes	0.31	11.58
Housing, water, electricity, oil/gas	0.21	12.72
Clothing	0.36	9.56
Health	0.06	7.00
Education, recreation, and sport	0.69	7.73
Transportation, communication, financial services	0.08	30.80
TOTAL	**0.45**	**15.15**

Source: Central Bureau of Statistics (BPS)

S&P Upgrades Indonesia's Currency Rating

On July 26 Standard & Poor's Rating Services announced that it had raised Indonesia's long-term foreign currency rating from B+ to BB-. This is the highest rating for Indonesia since the 1998 financial crisis and at the same level as the Philippines, Turkey, Ukraine and Serbia. Some analysts noted the upgrade was not expected until the fourth quarter. The upgrade may give a stimulus to economic growth. "While implementation remains a challenge, an encouraging development has been the speed at which difficult, but much-needed, reforms are happening, especially since the new economic team was put in place in December 2005," said S&P's credit analyst Sani Hamid. The upgrade puts S&P's rating on a par with Fitch Ratings but one notch above Moody's Investors Service.

Government debt may fall to less than 50% of gross domestic product (GDP) this year from more than 100% in 2000, S&P said in its statement. However, the external debt remains high and a burden, and proved unmanageable in the past. Lack of transparency in the finances of public sector-related entities, and in coordinating policies between the fiscal and monetary authorities; also remain issues that need to be resolved. S&P estimates cleaning-up cost associated with removing nonperforming loans from state-owned banks to reach 3% of GDP. Infrastructure shortfalls hampered competitiveness and economic growth is below potential. Analysts, however, expects external liquidity to strengthen through a combination of current surplus and improved investment flows. Hamid noted, “A faster implementation of reforms on taxes, labor, infrastructure development, and the legal structure, coupled with improved public sector transparency, would favorably influence the rating outlook on Indonesia.” Conversely, Indonesia's ratings may come under pressure should government delay reforms or reverse current fiscal policies.

GOI Submits 2006 Budget Revision to Parliament

On July 12, the Minister of Finance (MOF) presented to Parliament’s Budget Committee, mid-year revisions to the 2006 budget. In anticipation of higher government spending to help spur growth, the GOI increased this year’s budget deficit estimate to 1.3% of GDP from 0.7%. The MOF also revised the oil price assumption upward to USD 62/barrel from USD 57. Observers see this as the GOI’s attempt to avoid last year’s mistakes. In 2005, the GOI stood by a low oil price assumption in a rising global fuel price environment, leading to concerns about the swelling fuel subsidy and fiscal sustainability. The revisions for 2006 include a stronger exchange rate of Rp 9,300/USD instead of 9,900, and a higher benchmark interest rate of 12% up from 9.5%. Despite double digit YoY inflation in the first half of the year, the inflation estimate remained unchanged at 8%.

2006 Revised and 2007 Preliminary Budget Assumptions

	2005	2006	2006 Proposed Revision
Budget deficit (% to GDP)	0.9	0.7	1.2
Oil price (USD/barrel)	54	57	62
BI interest rate (%)	8.4	9.5	12.0
Exchange rate (Rp/USD)	9,800	9,900	9,300
Inflation (%)	8.6	8.0	8.0
GDP growth (%)	6.0	6.2	5.9

Source: Ministry of Finance

Bank Indonesia Governor Burhanuddin Abdullah said the revised growth assumption of 5.9% was more realistic, given that growth in the first half of the year would probably be in the 4.6-to-5.1% range. The GOI also anticipates higher government spending to reach Rp 689.5 trillion (USD 76 billion), or 22.1% of GDP, from the previous forecast of Rp 647.7 trillion (USD 71 billion) or 21.3% of GDP. The budget targeted higher tax, oil and gas revenues. The GOI expects this year’s deficit to rise to reach Rp 37.6 trillion (USD 42 billion). Most of the spending will go to domestic sovereign debt, fuel and electricity subsidies, education sector and social welfare. The increased deficit will require the GOI to raise more money from net bond sales, Rp 35.8 trillion (USD 4 billion) compared to Rp 24.8 trillion (USD 2.7 billion) under the original budget.

GOI Launches “Retail” Bonds

On July 17 the government launched Indonesia’s first-ever “retail” bond sold directly to individual customers without an auction process. The new three-year bonds pay interest monthly and offer a 12.05% fixed coupon. Individuals can place a minimum order of Rp 5 million (USD 551) with designated sales agents. Previous bond purchases required a Rp 1 billion (USD 110,000) minimum, making them beyond the reach of most individual investors. Minister of Finance Sri Mulyani Indrawati said the new bonds will encourage the development of an "investment society" in Indonesia, helping finance the country's development needs by expanding capital markets. The right to initially purchase the bonds is limited to Indonesian citizens, although non-nationals can buy them in the secondary market. "All the proceeds of the bond sales will go into the state budget," Mulyani said. She is positive about the market's appetite for the retail bonds, pointing out the main attractions of higher yields compared to bank deposits, and potential capital gains. President Director of state-owned Bank Mandiri Agus Martowardojo said that the retail bond sale was timely given the current bullish bond market and that the coupon rate was attractive. However, he said that the government needed to clarify its policies on taxation and funding sources to eliminate investor doubt. Mandiri is one of the 11 designated sales agents for the bonds. On August 7, the GOI earned Rp 3.3 trillion (USD 364 million) from the retail-bond sale, which will form part of the total Rp 35.8 trillion (USD 4 billion) in expected net proceeds from government bond sales this year.

GOI Sells 7-Year Bonds; GOI Swaps Soon Maturing Bonds

On July 12, the Ministry of Finance earned Rp 5.6 trillion (USD 617 million) in proceeds from bond sales. Rp 4.3 trillion (USD 474 million) of the bonds will mature in March 2013 at a weighted average yield of 12.21%, and another Rp 1.3 trillion (USD 143 million) bonds will mature in June 2021 at a 12.41% yield. The Director for Bond Management Rahmat Waluyanto said that the bullish market gave the government the upperhand during the auction, with only lower-yield bids being accepted. "I think these lower yields will be positive for the future development of our bond market," he said. Higher yields mean higher interest costs for the government. The government is bearing yields of nearly 13% for the same seven-year and 15-year bonds it first issued in January, and for the eight-year and 20-year bonds it sold during June's bond sale.

On July 25, the MOF swapped Rp 2.4 trillion (USD 265 million) of bonds maturing in 2007–09 for bonds maturing in 2021. The old bonds had yields of 9.5 - 14%, while the new bonds offer yields of 12.8% yield. On August 8, the MoF earned another Rp 4.4 trillion (USD 485 million) from a similar debt exchange within the same maturity and yield range. Those debt swaps are the latest in a series of MOF operations designed to reduce the amount of bonds coming due in 2007-09.

GOI and BI Launches Financial Sector Reform Policy Package

On July 5, the GOI and Bank Indonesia launched a policy package aimed at strengthening the banking industry, non-bank institutions and capital markets to boost the economy. The financial sector policy package contains 13 policies, 33 programs and 59 actions plans. (Note: This is the third of three policy packages announced by Coordinating Minister for Economic Affairs Boediono. The first two were for infrastructure and investment.) Minister Boediono stated, "The government realizes that development of the Indonesian financial sector to world class standards will be a dynamic process requiring successive stages. Accordingly follow-up financial sector policy packages will be developed in 2007 and beyond." Among the measures will be revisions to existing regulations on bank debt write-offs which may allow state banks further scope to restructure non-performing loans (NPLs).

According to the timeline in the package, Bank Indonesia will issue regulations providing incentives for merger and acquisitions in the banking sector by October. The GOI also plans to draw up a bill by December to strengthen coordination between fiscal and monetary authorities. For non-bank financial institutions, there are steps to strengthen their capital structures, and to handle insolvent institutions and introduce good governance principles. A team led by Boediono and Sri Mulyani will oversee these measures, to be completed this year and into 2007.

New Rules to Help NPL Problems

On July 10, the MOF announced as part of the financial sector reform package, a revision to Government Regulation No. 14/2005 and Finance Minister Decree No. 31/2005 regarding the procedures for non-performing loans (NPLs). The government hopes to complete the amendments by August, a month later than originally scheduled. The new regulations would allow the same flexibility for state-owned banks as for private banks in resolving NPLs. The upcoming regulation will allow state-owned banks to apply various debt restructuring options without having to first seek the approval of the Finance Ministry. "Our purpose is to provide a strong legal foundation for the handling of non-performing loans. All NPLs should be resolved by the state banks themselves," Mulyani said. In addition, the Ministry of State-Owned Enterprises will require state banks to sign a management contract to improve risk management to reduce NPLs. The President must approve the final draft in consultation with the Cabinet.

Partly due to high interest rates, the banking system's NPL ratio rose to 9.3% at the end of February 2006 compared to 8.3% at the end of December 2005. State-owned banks contributed the largest portion. State-owned banks have long called on the government to revise the regulations. They claim they have been restricted in restructuring their NPLs, due to an inability to provide debt reductions and other common restructuring options available to private banks.

GOI Closes Accounts

On July 25, the Ministry of Finance Director General for Treasury Mulia Nasution announced that the GOI had closed 300 accounts held in the name of individual government officials (current and retired). This is a response to findings of Supreme Audit Board (BPK) revealing that 957 government accounts with individual government officials names as account holders, amounting to Rp 20.5 trillion (USD 2.3 billion). The BPK submitted its "Performance Report of Central Government in 2004" to Parliament on September 2005. "There might be more accounts to close, and we are still reviewing them," Nasution said.

BI Signs MOU With Malaysia on Islamic Finance

On July 24, BI Governor Burhanuddin Abdullah, as the Head of the Board of the Indonesian Banking Development Agency (LPPI), and Malaysia's central bank governor Zeti Akhtar Aziz, as Head of Supervisory Board for International Center for Education in Islamic Finance (INCEIF), signed a Memorandum of Understanding (MOU) on improving human resources in the Islamic financial sector. Indonesia's President Susilo Bambang Yudhoyono and Malaysia's Prime Abdullah Ahmad Badawi witnessed the signing.

Banks Report First Half Performance

Several banks announced their performance for the first half of 2006 in July. Indonesia's largest state-owned Bank Mandiri reported on July 26 its net profit rose 32.4%, reaching Rp 4.9 trillion (USD 540 million), helped by a 6.5% higher net interest margin (NIM) over the previous year. Mandiri posted a net profit of Rp 815.44 billion (USD 90 million) in the January-June period compared to Rp 616 billion (USD 68 million) in the same period last year. With a market capitalization of USD 3.6 billion, Mandiri's second-quarter net profit alone stood at Rp 305 billion rupiah (USD 34 million), three times the year-ago period's figure. Mandiri, with its large volume of NPLs, was among the hardest hit banks last year due to higher rates and stricter central bank regulations on bad loans classification. Its net NPL ratio fell to 24.9% in the first half of 2006 compared with 26.2% as of June 30, 2005. Its "loss" category loans however, increased from Rp 12 trillion (USD 1.3 billion) to Rp 19 trillion (USD 2.1 billion) in the period.

On July 31, the second largest state-owned Bank Negara Indonesia (BNI) reported a 9% decrease in first-half net profit, partly due to lower loan demand and higher operating costs. BNI's net interest income rose only 1% year-on-year to Rp 3.7 trillion (USD 408 million), while operating expenses increased by 24% to Rp 2.8 trillion (USD 309 million). BNI's President Director Sigit Pramono commented, "With the still-high BI rate in the first half of the year, the real sector could not borrow significantly enough to stimulate the economy. Loan demand declined." The bank's NPL ratio increased to 11.23% from 7.82% previously. Loans to the corporate sector accounted for 51% of the total NPLs. The bank disclosed that the electricity sector dominated its top ten defaulters, with loans worth of Rp 3.5 trillion (USD 386 million). BNI will offer a discount to defaulters with debts under Rp 5 billion (USD 0.5 million) if they pay in full within three months. The discounts would decrease with every delay of three months.

Amid the high domestic interest rate, Indonesia's fifth-largest Bank Danamon and sixth-largest Bank Internasional Indonesia (BII), both affiliated with Singapore's Temasek Holdings, reported a significant drop in profit for first half of 2006. Danamon booked Rp

558 billion net profit (USD 61.5 million), a drop by 57% from Rp 1.3 trillion (USD 143 million) in the same period last year. BII recorded an 11% fall in net profit to Rp 352 billion (USD 39 million). Danamon reported a 16% growth in net interest margin (NIM), but had to write-off Rp 533 billion (USD 59 million) of assets while operating expenses increased significantly. BII also reported a growing NIM, but had to write-off Rp 196 billion (USD 22 million) of assets. Both banks reported a significant increase in loss category (grade 5 out of 5) and special mention loans (grade 2). Danamon's loans classified as "loss" reached Rp 733 billion (USD 81 million), doubled from Rp 331 billion (USD 36 million) from the previous year, while BII's increased to Rp 487 billion (USD 54 million) from Rp 322 billion (USD 36 million).

Bank Niaga, the seventh largest lender, booked a net profit of Rp 353.5 billion (USD 39 million) in the first six months this year, up nearly 15% from the same period last year. Its net interest income rose 29% to Rp 1.1 trillion (USD 121 million) from a year earlier on lending growth of 19% to Rp 30.65 trillion (USD 3.4 billion). Niaga's net NPL ratio improved slightly to 4.11% from 4.44% last year.

Rabobank Acquires Two Domestic Banks

Netherlands-based Rabobank announced on July 13 it had signed an agreement to buy two unlisted Indonesian banks, Bank Haga and Bank Hagakita, from individual shareholders. The two Indonesian banks, which primarily focus on small-to-medium enterprises (SMEs) in trading, manufacturing and business services sectors, have a combined 1,537 employees and a network of 78 branches in Java, Bali and southern Sumatra. The two banks have total assets of Rp 3.97 trillion (USD 438 million) as of December 2005. "Bank Haga and Bank Hagakita have an impressive track record of consistent growth since their founding 17 years ago. This is an exciting platform for Rabobank to grow our business in Indonesia," Fergus Murphy, head of Asia region for Rabobank International said. The press release said the acquisitions are consistent with Rabobank's strategy of being the world's leading financier in the food and agribusiness sectors. It did not provide the size of the acquisition or its value. Rabobank, the world's 14th largest bank in terms of Tier I capital, has an Indonesian subsidiary, Bank Rabobank International Indonesia, which has been in business for 16 years and focuses primarily on corporate clients

Selected Economic, Monetary & Financial Statistics

	Apr 06	May 06	Jun 06	Jul 06
CPI Inflation (YoY)	15.40	15.60	15.53	15.15
CPI Inflation (MoM)	0.05	0.37	0.45	0.45
Rp/USD Exchange rate [1]	8,775	9,220	9,300	9,070
30-day SBI Interest Rate [2]	12.75	12.50	12.50	12.25
Foreign reserves [3]	42.8	44.2	40.1	41.1
JSX Composite Index	1,464	1,330	1,310	1,352
Exports (USD billion)	7.6	8.3	8.5	
% Change (YoY)	*11.9*	*13.4*	*15.1*	
Import (USD billion)	4.8	5.1	5.7	
% Change (YoY)	*-3.7*	*-2.1*	*1.3*	
Trade Balance [5]	2.8	3.2	2.8	

Source: Bank Indonesia, BPS

(1) Rp/USD, end of period

(2) End of period

(3) USD billions, end of period

(4) Jakarta Stock Exchange average daily transaction volume, in billions of shares

(5) USD billions

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